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# Building Scale in Community Impact Investing through Nonfinancial Performance Measurement

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## Abstract

The measurement of nonfinancial performance is becoming increasingly important in the community impact investing industry, where individuals and institutions actively deploy capital in low-income domestic markets for both financial and social returns. Quality data ensure that the creation of jobs, construction of community facilities, financing of affordable housing, and other benefits that characterize the sector are delivered cost-effectively and transparently. This paper discusses the limited practice and future direction of nonfinancial performance measurement by revisiting four key questions:

1. Does nonfinancial performance measurement really matter for investors?
2. If it does matter, is nonfinancial performance measurement even possible?
3. If nonfinancial performance is possible to measure, what form should it take?
4. How will nonfinancial performance measurement increase community impact investing?

The paper examines the barriers to a more robust regime of nonfinancial performance measurement and posits both that innovation in the sector ought to be driven by the discrete but explicit needs and demands of investors, and that greater accountability has a special role to play in making disclosure more attractive. The report concludes that nonfinancial performance measurement directly informs the investment process and is essential to growing community impact investing because it provides latent sources of capital with market-level information on the tradeoffs between financial and social return. Although the industry is unlikely to discover the "silver bullet" of nonfinancial performance measurement in the near future, there is reason to be hopeful: measurement strategies can – and will – converge through private- and public-sector innovation.

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## Part I: Introduction

Nonfinancial performance measurement has become a significant focus of the community impact investing industry, where individuals and institutions actively deploy capital in low-income domestic markets for both financial and nonfinancial return. Many industry stakeholders have a growing need for effective measurement -- the practice of evaluating and reporting the nonfinancial value that accrues to an investor from investments with a primary or ancillary social objective. Even so, others within the industry doubt that nonfinancial performance measurement is beneficial to investors at all. And there are those who simply find measuring nonfinancial performance difficult and frustrating because of bad data, poorly suited practices, or the volume and diversity of measurement tools that have emerged in recent years. Even as the industry continues to build much-needed infrastructure for evaluating nonfinancial returns on investment, our research suggests that, as a first step, understanding investor preferences and behaviors is critical to more effectively measuring performance.

This aritcle has three main sections. The first discusses the diversity of community impact investors and investments. The second highlights existing nonfinancial performance measurement tools and practices. It also describes the three key impediments to nonfinancial performance measurement: varied and ambiguous investor preferences; inadequate tools and practices; and a lack of accountability for nonfinancial return. The third section provides a framework for advancing nonfinancial performance measurement from an investor-centered perspective, asserting that investors' nonfinancial performance objectives ultimately inform, and are informed by, measurement tools and practices. This third section presents four questions that the field must consider in order to advance:

1. Does nonfinancial performance measurement really matter for investors?
2. If it does, is nonfinancial performance measurement even possible?
3. If it is possible, what form should it take?
4. How will nonfinancial performance measurement increase community impact investing?

Answering each of these questions in sequence, the third section introduces innovation and accountability as key factors that shape investor preferences for measuring and reporting nonfinancial return. We can derive additional insight not by classifying investors as "financial-first" or "impact-first" (the preferred binary approach in the research), but by placing them on two continua: one representing investors' willingness to pay for nonfinancial return, a unique indicator of the value an investor attributes to community impact; and one representing investors' willingness to disclose, which indicates the extent to which an investor is willing to be accountable for, and report, nonfinancial return. The article concludes by discussing opportunities for further research and market development.

Although "impact investing," broadly defined, has been coined to capture the diversity of capital actively seeking social and environmental benefits around the globe, the term "community impact investing" in this report refers only to low-income domestic markets, and only to investments targeting social returns, for example, in the areas of economic, workforce, and entrepreneurial development; housing; education; and health. The research focuses on the nonfinancial performance measurement tools and practices used by those investors hoping to at least recoup the principal sum of their investment. By extension, the research does not address evaluation activities at the purely philanthropic level.

Certainly there is a much larger universe of impact investing and nonfinancial performance measurement, including advanced efforts internationally and in sectors such as environmental sustainability and shareholder engagement. Although some of the nonfinancial performance measurement challenges in these areas mirror those we discuss in this report, there are distinctive qualities in U.S. community finance that call for a more narrow scope of research, not least in the type of investors in the sector and the regulatory environment in which they operate. Similarly, grant making in the community-based sector is an example of a more mature kind of social impact evaluation. But again, the conditions in which grant recipients and donors measure performance differ from those in community impact investing, where funding is directly contingent on both delivering and proving impact, and thus creating very clear financial incentives for those involved.

***Research Evolution and Methodology***

This project has required a change in tack multiple times, ultimately leading, in our opinion, to a compelling understanding of why nonfinancial performance measurement is important for scaling the sector. At the outset of the project, the goals were as follows: synthesize existing research on nonfinancial performance measurement, survey the landscape of performance measurement tools, and provide specific recommendations for advancing the field. We hoped to discover the specific metrics, the nonfinancial performance measurement tools, and the ideas with the best prospects for drawing additional capital into community impact investing – in other words, the "silver bullets." Although we met some of these initial goals, the direction of the project shifted. Rather than providing a framework for evaluating performance measurement tools, our research pointed to the need for a new emphasis on the behavior of investors, as informed in part by measurement tools and practices. Although the industry has put much thought into how to measure nonfinancial performance, the research illuminated prerequisite considerations including whether or not it should be done at all and, if so, why? By understanding the answers to these questions first, and approaching them through an investor-centered lens, the industry can address common barriers, better serve investors, and more successfully pursue effective nonfinancial performance measurement, ultimately leading to additional capital investment in the industry.

The research was conducted from December 2009 to August 2010 and included an extensive review of existing literature on impact investing and nonfinancial performance measurement. An important resource throughout the project has been the report "Investing for Social and Environment Impact", published by the Monitor Institute in 2009. This report outlines the current state of the broader impact investing industry and presents an important discussion on the steps necessary to build scale in the sector. Our research builds on a central thesis in the Monitor Institute report: that measurement of nonfinancial returns is one critical prerequisite for industry growth.[2]

The research involved surveys of and in-depth interviews with industry stakeholders including impact investors and performance measurement experts. This process, combined with the literature review, identified the barriers to nonfinancial performance measurement and the tools that exist to measure nonfinancial return. The interviews also provided important insights into the investor preferences at the center of our analysis. Finally, the research included a review of nonfinancial performance reporting and disclosure in annual reports of banks, nondepository financial institutions, community development financial institutions (CDFIs), and foundations making community impact investments.

***Definitions***

This paper discusses a number of concepts using the following terminology.

> **Community impact investing** involves actively placing capital in businesses, funds, and other opportunities that generate social good in low-income communities and return at least the principal to the investor.
>
> **Community impact investment industry**, also called "the industry," includes community impact investors, the vehicles by which investors make their investments, the underlying investments, and the measurement tools used to describe financial and nonfinancial return.
>
> **Community impact investors** are entities that actively deploy capital for social impact in low-income domestic markets – including in the areas of economic, workforce, and entrepreneurial development; housing; education; and health – regardless of whether the entity invests directly or through an intermediary.
>
> **Nonfinancial return** is the social benefit or other nonfinancial value that accrues to an investor from an investment.
>
> **Performance measurement tools**, for the purposes of this project, are tools designed to report on the nonfinancial return of investments.

2 Jessica Freireich and Katherine Fulton, "Investing for Social and Environmental Impact." (New York: Monitor Institute, January 2009).

**Willingness to pay** is a measure of the quantity of time, effort, investment earnings, or other resources that investors are willing to exchange for a preferred value of nonfinancial return.

**Willingness to disclose** is a measure of the quantity and quality of reporting of nonfinancial returns that investors are willing to provide to the stakeholders to which they are accountable.

## Part II: The Community Impact Investing Industry

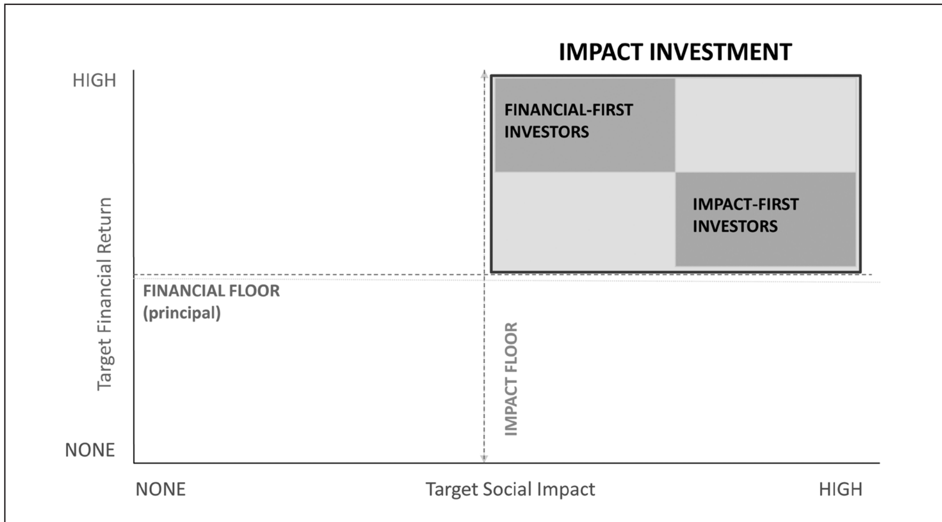
The community impact investing industry represents the combined efforts of a mixed group of individuals and institutions actively deploying capital in low-income domestic markets for financial and nonfinancial return. It is a cohesive industry, but one that is also diverse and multifaceted. It is subsidized in part by government regulations and programs, yet characterized by significant levels of innovation, particularly in the engineering and layering of products with disparate risk and return profiles to accommodate the very different financial and nonfinancial objectives of investors.

### *2.1 Community Impact Investors*

At the broadest level, the current literature categorizes community impact investors on the basis of their investment motivation: financial-first or impact-first.[3] Financial-first investors seek to optimize financial returns, with a minimum requirement for social or environmental impact. They are generally commercial investors searching for subsectors that offer a market rate of return but yield some social good.[4] Impact-first investors seek to optimize social or environmental performance while maintaining a floor for financial returns. They accept a range of returns, from principal-only to market rate, and seek social good as a primary objective.[5] Figure 1 illustrates this conception of the market.

3 Ibid, 32.
4 Steven Godeke and Raúl Pomares, "Solutions for Impact Investors: From Strategy to Implementation." (New York: Rockefeller Philanthropy Advisors, November 2009),11.
5 Ibid, 12.

*Figure 1: Motivations of Impact Investors*[6]




For many years, most investors in the community impact investing market have tended to be impact-first, including regulated special-purpose community development institutions, government, philanthropic foundations, banks motivated by regulatory mandate, and private individuals. Recent investors in the sector, who will likely come to provide a considerable proportion of new capital, tend to be financial-first, including nondepository institutions and investment funds.[7]

For the purposes of this research, community impact investors are entities that are actively deploying capital in low-income domestic markets for financial and nonfinancial return, regardless of whether they invest directly or through an intermediary. These investors fall into one of five structural categories: government, depository institutions, nondepository institutions, individuals, and foundations. We describe each category in turn.

**Government**

The public sector is a significant source of community impact investment at all levels. Federally, the CDFI Fund, within the U.S. Department of Treasury, channels financial support directly to the community development financial institutions (CDFIs) that register with the Fund. The Fund also administers the New Markets Tax Credit program, which we discuss in more detail under "depository financial institutions."

6 Freireich and Fulton, "Investing."
7 Ibid, 49.

The CDFI Fund was created by the 1994 Riegle Community Development and Regulatory Improvement Act to promote economic revitalization and community development through investment in and assistance to CDFIs. CDFIs are investment organizations whose primary mission is promoting community development in designated markets underserved by traditional capital. The CDFI Fund attracts an estimated $20 in non-federal government investments to the sector for every dollar provided to CDFIs.[8] Since 2003, the CDFI Fund has provided 436 financial assistance awards and a total of $346 million in financial assistance.[9]

Aside from the CDFI Fund, the federal government has invested in discrete sectors of the industry. For example, the government-sponsored enterprises Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are active in real estate in low-income areas. The New Markets Venture Capital program, created in 2003 and administered by the Small Business Administration to promote economic development and job opportunities in low-income areas, helped to seed six new venture capital funds.[10] At the sub-federal level, significant investors and co-investors include economic development agencies, state housing finance agencies, and other public-sector entities.

The federal government also uses other subsidy sources, such as the Low Income Housing Tax Credit and block grants (including the Community Development Block Grant and HOME Investment Partnership), to entice more community impact investment in low- and moderate-income (LMI) areas.

**Depository Institutions**

Depository institutions, the backbone of the community impact investment sector, include community development banks and credit unions specifically created to work in markets underserved by traditional capital, as well as all others commercial banks and thrifts motivated by the Community Reinvestment Act (CRA). Depository institutions created to make community impact investments include the over 350 community development banks and over 290 community development credit unions registered with the CDFI Fund.[11]

Community development banks are FDIC-insured and federally regulated for-profit organizations with community board representation. Assets grew from $2.4 billion in 2001 to $13.7 billion in 2007.[12] These institutions act like traditional banks but operate in low-income target markets. Community development credit unions, which offer the same services as conventional credit unions, are member-owned nonprofit organizations regulated

8 Ben Bernanke, "By the Numbers: Data and Measurement in Community Economic Development," Community Development Investment Review 3 (2) (2007), 5.

9 CDFI Fund Award Database, www.cdfifund.gov. Financial assistance is just one of the forms of support provided by The CDFI Fund, which also awards grants for technical assistance, native initiatives, bank enterprise awards, and administers the New Markets Tax Credit program.

10 www.sba.gov. The SBA also has a Rural Business Investment Program, which catalyzed the creation of one additional venture capital company.

11 CDFI Data Project, Community Development Financial Institutions: Providing Capital, Building Communities, Creating Impact, 7th Ed. (Cleveland, OH: CDFI Data Project, 2007).

12 Ibid.

and typically insured by the National Credit Union Administration and/or by state agencies. They have grown rapidly in assets from $2.8 billion in 2001 to $7 billion in 2007.[13]

The primary motivation for traditional depository institutions to make community impact investments is the 1977 Community Reinvestment Act (CRA), which is intended to "encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound operations."[14] The CRA mandates that all depository institutions receiving FDIC insurance demonstrate a positive record for helping meet the credit needs of their entire community. According to CRA guidelines, an appropriate federal banking agency evaluates each depository institution periodically, taking its record into account in considering any application for new branch offices or mergers and acquisitions. Federal banking agencies involved in evaluation include the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. Among the 998 institutions that reported CRA-motivated lending in 2007, 746 institutions extended $63.8 billion in community development loans.[15]

Depository financial institutions have also been bolstered by the federal government's New Markets Tax Credit (NMTC) program. The NMTC is administered by the CDFI Fund and allocates tax credits to certified community development entities (CDEs), which then provide the tax credits to private investors. CDEs must invest the entire private investments in low-income communities. Like CDFIs, many of which are also CDEs, CDEs are domestic corporations with a primary mission to serve or provide investment capital to low-income communities. The CDFI Fund has made 495 NMTC awards totaling $26 billion.[16] Although nondepository institutions typically have the largest number of deals, banks claim the largest proportion of the flow through credits.[17]

**Nondepository Institutions**

Nondepository institutions include those created specifically for the purpose of community investment–community development loan funds and community development venture capital funds registered with the CDFI Fund–as well as various pension funds, insurance companies, financial advisors, and investment funds investing for financial and nonfinancial returns.

13 Ibid.
14 Community Reinvestment Act, 12 U.S.C. § 2901 et seq. (1977).
15 www.ffiec.gov.
16 www.cdfifund.org.
17 Government Accountability Office, "Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance." Report no. GAO-07-296. (Washington, DC: GAO, January 2007). See also Lauren Lambie-Hanson, "Addressing the Prevalence of Real Estate Investments in the New Markets Tax Credit Program." (San Francisco: Federal Reserve Bank of San Francisco, Working Paper 2008-04).

Community development loan funds are primarily nonprofit organizations certified by the CDFI Fund that are created to lend in target markets to businesses, real estate and housing developers, nonprofit organizations, and individuals that are typically unable to obtain capital at favorable terms from traditional sources.[18] Assets in the sector, which includes more than 500 funds, have grown from $3.1 billion in 2001 to $4.6 billion in 2007.[19]

Community development venture capital funds, mostly organized as for-profit LLCs and limited partnerships, invest equity and equity-like debt in small companies with the potential for rapid growth in underserved communities. Assets in the sector, which includes around 70 funds, have grown markedly, from $300 million in 2001 to $2 billion in 2009.[20]

Some nondepository, non-CDFI institutions are also motivated to deploy capital to community impact investment opportunities by stringent mandates or the long shadow of regulation, although such oversight tends to be at a sub-federal level. For example, the trustees of a number of significant public pension funds require that the institutions make economically targeted investments with ancillary social objectives such as urban revitalization, supporting underserved markets, or economic development more broadly.[21] Another example is insurance companies doing business in California, which are subject to California Organized Investment Network (COIN) guidelines that require investment in community development. COIN, a collaborative effort between the California Department of Insurance, the insurance industry, and community affordable housing and economic development organizations, was established as an alternative to state legislation, much like the CRA, that would have required that insurance companies invest in underserved communities.[22]

**Investing Foundations and Endowments**

Philanthropic organizations, including corporate, community, religious, and especially private foundations, are some of the core capital providers to the community impact investment industry. For example, since 1986, the John D. and Catherine T. MacArthur Foundation alone has provided $250 million in grant and program-related investment (PRI) support to CDFIs.[23]

Private foundations tend to invest in community impact in one of two ways: through PRIs, which are investments with an explicit charitable purpose, generally made to advance a foundation's mission with the expectation of earning a highly concessionary financial return; and through mission-related investments (MRIs), which are market-driven investments that

18 Julia Sass Rubin, Financing Organizations with Debt and Equity: The Role of Community Development Loan and Venture Funds, Chapter 5. (New York: Russell Sage Foundation, 2007).
19 CDFI Data Project, Community Development Financial Institutions.
20 Kerwin Tesdell, "Community Development Venture Capital" (PowerPoint presentation, New School, New York, NY, April 1, 2010).
21 Lisa Hagerman, Gordan L. Clark, and Tessa Hebb, "Investment Intermediaries in Economic Development: Linking Public Pension Funds to Urban Revitalization," Community Development Investment Review 3 (1) (2007).
22 Information from www.impactcapital.net and www.insurance.ca.gov/0250-insurers/0700-coin/.
23 www.macfound.org. From the press release "CDFIs Receive Funding to Support Charter Schools," 2010.

typically originate from a foundation's endowment corpus and are expected to generate a market return but also to have social impact. From 1990 through 2008, foundations invested approximately $3.7 billion in 5,400 PRIs, albeit in a tremendous diversity of markets. In 2005 and 2006, the community impact investment sector accounted for at least 30 percent of PRI allocations.[24] The foundation category also includes "place-based" institutions such as colleges, hospitals, and other large pools of endowment capital with a clear interest in supporting local community infrastructure and development.

**Individuals**

Tens of thousands of individuals, including bank customers, mutual fund investors, and wealthy families, represent a critical source of capital to the community impact investment sector. For example, Trillium Asset Management, the $1 billion independent investment advisor devoted to sustainable investing for high net worth families, individuals, foundations, endowments, religious institutions, and other nonprofits, recently added a fifth CDFI to its list of community investment organizations available for client investment.[25] Individuals also account for about one-third of NMTC claimants[26] and over 40 percent of CDFI bank deposits.[27]

### *2.2 Community Impact Investments*

This diversity of investors is matched only by the breadth of available community impact investments, which generally fall into three broad categories: investments by CDFIs and other special-purpose vehicles; investments using CDFIs as intermediaries; and investments in non-CDFI-driven opportunities. These categories of investments are not mutually exclusive, but rather overlap with each other, as illustrated in Figure 2. In fact, it is precisely the malleable nature of the market that spurs product innovation. Product innovation, which is key to attracting additional sources of capital, has typically been aimed at blending investments, particularly by leveraging public- and philanthropic-sector concessionary capital to better package, manage, and mitigate risk for other investors, including the most financially motivated ones.[28]

24 Foundation Center, The PRI Directory: Charitable Loans and Other Program-Related Investments by Foundations (New York: Author, 2009). Based on PRI transactions of $10,000 or more. The share to community impact investments is calculated from 2006–2007 data, using the investment categories of "economic/community development" and "housing and shelter."

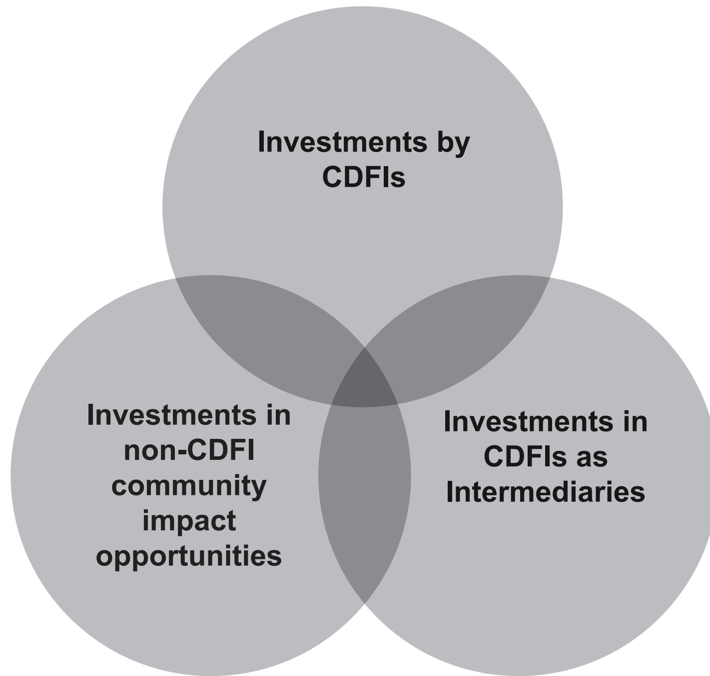
25 Trillium Asset Management, "Social Research & Advocacy: A Record of Accomplishment." Press release (Boston: Trillium, January 2007), available at http://trilliuminvest.com/pdf/tamc_2007_socialreport.pdf.

26 GAO, "Tax Policy."

27 Community Development Financial Institutions Fund, Three Year Trend Analysis of Community Investment Impact System Institutional Level Data, FY 2003-2005, Washington, DC, December 2007, in Paul Weech, "Observations on the Effects of the Financial Crisis and Economic Downturn on the Community Development Finance Sector." In The Economic Crisis and Community Development Finance: An Industry Assessment. Working Paper 2009-05 (San Francisco: Federal Reserve Bank of San Francisco, June 2009); 26-39.

28 Godeke and Pomares, "Solutions for Impact Investors."

*Figure 2: Community Impact Investments*




**Investments by CDFIs**

The investments by CDFIs and other special-purpose vehicles[29] include the loans, equity and debt-with-equity investments, guarantees, and loan sales that form the core of CDFI offerings.[30] Of the $17.6 billion in CDFI financing outstanding at the end of 2007 from banks, credit unions, and loan funds, 99 percent comprised loans.[31] The remainder primarily financed equity funds under the purview of banks, credit unions, and loan funds. Assets managed by the community development venture capital sector represent an additional $2 billion.[32] CDFIs have an explicit social mission, with objectives in community impact markets including economic development (such as job creation, business development, and commercial real estate development), affordable housing (including housing development and homeownership), and community development financial services (such as the provision of basic banking services to underserved communities and financial literacy training).[33]

29 "CDFIs and other special-purpose vehicles" is loosely defined to include CDFIs, CDEs, and any other entities required by regulation and supported by subsidy to make community impact investments. Opportunity Finance Network's Mark Pinsky calls this broader definition Community Development Investors – 'CDFIs, state housing finance agencies, bank community development lending teams or activities, as well as community development producers and asset managers such as CDCs, for-profit affordable housing developers, and others' (Pinsky 2009, 9).
30 CDFI Data Project, Community Development Financial Institutions.
31 Ibid.
32 Tesdell, "Community Development Venture Capital."
33 CDFI Fund, www.cdfifund.gov.

**Investments using CDFIs as Intermediaries**

CDFIs and other special-purpose vehicles play a critical role in the industry primarily as intermediaries and hubs for innovation. For investors far from the action who have little capacity for the difficult work of identifying and making investments with social impact, CDFIs are the logical path to implementation. For example, in November 2009, Goldman Sachs announced that it would invest $300 million through a combination of lending and philanthropic support to CDFIs in order to "increase the amount of growth capital available to small businesses in underserved communities and to expand the capacity of CDFIs to deliver enhanced technical assistance to small businesses."[34] CDFI capital under management comes from a diverse group of investors. For depository CDFIs, these include individuals (42 percent), private financial institutions including CRA-motivated banks (15 percent), and government (3 percent). For nondepository CDFIs, key capital providers include CRA-motivated banks (29 percent), government (16 percent), and philanthropic entities (12 percent).[35]

NMTCs also flow through CDFIs and other special-purpose vehicles into the hands of non-CDFI investors. The three largest NMTC claimants are banks and other regulated financial institutions (38 percent), individual investors (32 percent), and other corporate investors (18 percent).[36] When the U.S. Government Accountability Office (GAO) asked investors to specify which factors had a "very great" to "moderate effect" on their decision to invest in the NMTC program, responses included the wish to improve conditions in low-income communities (90.1 percent), obtain return on investment (82.1 percent), create or retain jobs (77.8 percent), obtain the tax credit (76.7 percent), expand lending relationships with special-purpose borrowers (52.0 percent), and comply with government regulations like the CRA (41.2 percent).[37]

Product innovation is critical to providing access to the community impact investing sector for many investors through CDFIs. Examples include:

- The first rated pool of securities backed by community development assets, known as CRF-17 (Community Reinvestment Fund USA Community Reinvestment Revenue Notes, Series 17): More than half of the investment classes in CRF-17 were rated AAA by Standard & Poor's (S&P), which used the Small Business Administration's Section 504 program as an alternative information source for assessing the quality of securities rather than CRF's more limited performance track record.[38]
- Tranched structures like the New York Acquisition Fund.[39] This fund leverages

34 Goldman Sachs, "Goldman Sachs Launches 10,000 Small Businesses Initiative." Press Release (New York: Goldman Sachs, November 17, 2009)
35 Weech, "Observations", 28.
36 GAO, "Tax Policy."
37 Ibid.
38 M. Swack and N. Giszpenc, eds., "Financial Innovations Roundtable: Developing Practical Solutions to Scale up Integrated Community Development Strategies." Report no. 8. (Durham: Carsey Institute, University of New Hamphire, 2009), 13.
39 www.nycacquisitionfund.com.

government grants and subsidized foundation capital to fund a $230 million pool for bridging the period between property acquisition and construction closing in order to finance the construction and preservation of affordable housing. The fund's originating CDFI lenders include the Corporation for Supportive Housing, the Enterprise Community Loan Fund, the Low Income Investment Fund, and the Local Initiatives Support Corporation.[40]

- Intermediaries that aggregate capital and provide due diligence to CDFIs. Examples of these intermediaries include the Calvert Foundation, Trillium Asset Management, and Domini Social Investments. For example, in September 2009, the Calvert Community Note had invested approximately half of $170 million in domestic loans and companies, partly on behalf of individuals with as little as $1,000 to invest.[41]

**Investments in Non-CDFI-Driven Opportunities**

The community impact investing industry becomes more difficult to demarcate once it moves beyond the territory of the more visible CDFI sector. It is perhaps easiest to describe the diversity of investor activities and product preferences anecdotally, as in the following examples:

- The economically targeted investments of public employee pension funds we discussed earlier were estimated in 2007 to include $11 billion of commitments to urban revitalization, emerging domestic markets, or economic development more broadly.[42] Many of these funds are invested outside the realm of CDFIs.
- More than $133 million invested since 1992 by angel investors, professional venture capitalists, foundations, and family offices in more than 200 companies and small funds addressing social and environmental issues, facilitated by Investor's Circle.[43]
- Targeted private-sector socially responsible investment activities include the JP Morgan Urban Renaissance Property Fund, which has $175 million of capital for investing in the "development and redevelopment of real estate projects in market rate, affordable and workforce housing, retail, mixed-use development, hospitality and other real estate sectors in Urban Renaissance Markets."[44]
- $10 billion has been invested with venture capital companies that target minority-owned businesses, of which 51 percent is attributable to pension funds.[45]

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40 Antony Bugg-Levine and John Goldstein, "Impact Investing: Harnessing Capital Markets to Solve Problems at Scale," Community Development Investment Review 5 (2) (2009), 37.

41 Calvert Community Note, Social impact report 2009.

42 Hagerman, Clark and Hebb, "Investment Intermediaries in Economic Development."

43 www.investorscircle.net.

44 Tracy Pun Palandijan, "Investing for Impact: Case Studies Across Asset Classes." (Parthenon Group, Bridges Ventures, and Global Impact Investing Network, March 5, 2010), 23.

45 Data from both the National Association of Investment Companies website, www.naicvc.com, and T. Bates and W. Bradford, "Traits and Performance of the Minority Venture-Capital Industry." Annals of the American Academy of Political and Social Science 613 (1) (2007): 95–107.

**Financial Performance in Community Impact Investing**

Perhaps the only characteristic that truly unites investors and investments in the community impact investment sector is their extraordinary variety. In no small measure, the growth of the industry depends on this very diversity, by bringing together investors that need exposure to the same asset class and engineering products that allow some to satisfy social priorities and others to meet financial obligations. The Monitor Institute calls these initiatives "Yin-Yang" deals, blending different types of capital with different requirements and motivations.[46] In short, the very premise of community impact investing – the structural bias and explicit preference of many investors for social impact over and above investment performance – makes any attempt to describe financial return not only fraught with difficulty, but in many respects irrelevant. Community impact investing reflects the "blended value" proposition that Jed Emerson promotes:

> All organizations, whether for-profit or not, create value that consists of economic, social and environmental value components – and that investors (whether market-rate, charitable or some mix of the two) simultaneously generate all three forms of value through providing capital to organizations. The outcome of all this activity is value creation and that value is itself non-divisible and, therefore, a blend of these three elements.[47]

Financial return often appears to be just one variable that an investor can readily and knowingly trade for another, such as mitigated risks or enhanced social impact. This is true for many community impact investors, but certainly not for all. A growing number, including those with the largest pools of nondepository capital who are now starting to enter the sector, insist that social impact can, and must, be additive, requiring no diminishment of financial returns.

There is reason to believe that this is possible. For example, in the private equity sector, the products in which nondepository institutions have invested appear to have delivered a market rate of return. This includes private equity funds investing in minority-owned businesses, which have produced financial returns that are comparable to or higher than those of conventional venture capital funds, and at least two larger funds that target job creation in low-income communities.[48] One of these, the Bay Area Equity Fund, had raised over $86 million for its second investment partnership as of July 2010; another, Pacific Community Ventures, is expected to raise an equally ambitious fourth fund shortly, primarily on the strength of the performance of its third.[49] In real estate, the return on economically targeted investments of the New York City Employees Retirement System was reported to be 6.5 percent for the three years preceding June 2008, versus 5.48 percent for the benchmark

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46 Freireich and Fulton, "Investing." 32.

47 www.blendedvalue.org.

48 Bates and Bradford, "Traits and Performance."

49 From the Securities and Exchange Commission filing for DBL Equity Fund - BAEF II, available at: http://sec.gov/Archives/edgar/data/1453736/000095010310002078/xslFormDX01/primary_doc.xml.

Lehman Aggregate.[50] In fact, in the context of pension funds investing in urban revitalization, nonfinancial return is often referred to as "extra-financial" return.[51]

Not surprisingly, many community impact investments generally underperform traditional financial markets. In equity, the typical community development venture capital fund has been characterized as delivering returns in the range of 5–10 percent as compared to 20–30 percent for the SBA's Small Business Investment Company program, which supports a traditional venture capital model.[52] In the area of debt investments, two of the only mutual funds pooling CRA-qualified loans – one managed by Access Capital Strategies, a part of RBC Global Asset Management, and another by the Florida-based investment company Community Capital Management – have underperformed the market benchmark by 0.37 percent and 1.05 percent, respectively, over the past five years.[53] At an institutional level, CDFI Fund awardees tend to have fewer total assets, higher loan delinquency and charge-off rates, and lower returns on assets than their non-CDFI contemporaries.[54] In recent years, CDFI banks and thrifts have been hit hard by the recession. The ratio of median noncurrent loans to total loans deteriorated from 2.2 percent at the end of 2007 to 3.82 percent at the end of 2009, whereas the all-banks median ratio was 1.76 percent. Median return on assets at CDFI banks fell from 0.71 percent in 2007 to 0.02 percent in 2009, below the all-bank median of 0.47.[55]

Although the role and importance of traditional market-rate returns in community impact investing may be heightened by the entry of more financially motivated investors, the unique social benefits that community impact investments provide will continue to justify below-market returns for the many investors who highly value nonfinancial performance.

## Part III: Measuring Nonfinancial Return on Investment

There is a wide variety of types of investors and vehicles in which they invest.[56] In keeping with such diversity, community impact investors demonstrate nonfinancial returns using a wide range of tools and practices to measure performance. As more investors provide capital to the industry, the notion of nonfinancial performance measurement becomes more important, even as barriers emerge to prevent effective implementation. The following section

50 Comments from New York Comptroller William Thompson Jr., the sole trustee of the New York City Employees Retirement System, in Benjamin Sarlin, "Comptroller: Pension Funds Can be Social Change Engines." Sun, June 11, 2008.

51 Lisa Hagerman, "More Than a Profit? Measuring the Social and Green Outcomes of Urban Investments," 4. (Cambridge, MA: Harvard Law School Labor & Worklife Program, July 2007).

52 Senator John Kerry, The American Community Renewal and New Markets Empowerment Act, S2779, 106th Congress, Congressional Record 146 (2000): S5684.

53 www.Morningstar.com.

54 S. Rajan, "Measuring the Financial Soundness of CDFIs." (Cambridge, MA: Kennedy School Policy Analysis, April 2001).

55 National Community Investment Fund, The CDFI Banking Sector: 2009 Annual Financial and Social Performance. (Chicago: NCIF, 2009). 32

56 Hagerman, "More than a Profit?", 11.

discusses the methods by which we can evaluate nonfinancial return and the impediments to the development of more effective approaches. The section surveys a number of existing tools and discusses current innovations in the field.

### *3.1 Nonfinancial Performance Measurement Practices*

The growth of community impact investing to include more institutional investors such as public-sector pension funds, foundations, banks, insurance companies, and faith-based organizations has greatly increased the potential for social benefit.[57] However, only through performance measurement can we understand the true value of the social impact, and thus its benefit.[58] The entry of more investors with more investment capital into the field has emphasized the importance of understanding nonfinancial performance. High-quality measurement and reporting provide investors with the data they need to make informed choices.[59]

Investors who measure nonfinancial returns use a variety of methods and metrics that are typically aligned with the asset class in which they invest. The amount of detail in reports of nonfinancial returns also varies substantially. For example, the $170 billion California Public Employees Retirement System (CalPERS) uses the third-party services of Pacific Community Ventures (PCV) to measure the "ancillary" benefits of its $1 billion California Initiative, a private equity fund targeting underserved markets in California. PCV uses detailed, customized metrics including jobs created, employee benefits, low-income workers supported, and female and minority ownership and management at the underlying companies in which CalPERS invests.[60] CDFIs, on the other hand, have converged on the more limited, standardized metrics required by the CDFI Fund's Community Investment Impact System (CIIS), including jobs created and affordable housing units or community facilities financed and created.

In order to further illuminate nonfinancial performance measurement and reporting practices, our research included a review of a number of annual reports published by community impact investors including banks, foundations, CDFIs, and nondepository institutions; these reports indicated significant differences and clear trends across investor categories. Some highlights and general observations are listed below:

- Few impact investors surveyed include nonfinancial performance in annual reports. Any measures reported are usually published separately or only on the investor's website.
- CDFIs reported nonfinancial performance in the greatest depth, with measures of job

57 Bugg-Levine and Goldstein, "Impact Investing."

58 Lisa Hagerman and Janneke Ratcliffe, "Increasing Access to Capital: Could Better Measurement of Social and Environmental Outcomes Entice More Institutional Investment Capital into Underserved Communities?" Community Development Investment Review 5 (2) (2009), 44.

59 Hagerman, "More than a Profit?," 34.

60 CalPERS, 2010 Annual Report.

creation, housing units and commercial/facilities spaces financed, number of individuals served, and minority group representation, as illustrated by the Louisville Community Development Bancorp (see Figure 3).

*Figure 3: Louisville Community Development Bancorp*

**Reporting of Nonfinancial Performance**

*The Bancorp gauges success with five simple measurable objectives:*

1. *Stimulate small business expansion. Measured by the number of commercial loans made, businesses assisted, jobs created, and technical assistance customers served.*
2. *Increase home ownership. Measured by the number of families owning homes as a result of Bancorp activities.*
3. *Improving the quality and value of real estate. Measured by the number of acquisition/rehab loans, housing units developed, and home or commercial site improvement loans.*
4. *Increase the quantity of available goods and services. Measured by the number of loans to firms providing needed goods and services in the neighborhoods served.*
5. *Connect residents to career path employment. Measured by the number of jobs created.*

- Banks, in particular, use nonfinancial performance primarily as a marketing and branding tool in annual reports, featuring stories and photographs but no accompanying analysis. All of the major banks we sampled published separate corporate citizenship/CSR reports or disclosed CRA lending volume on websites. For example, Wells Fargo reports that “affordable housing projects in communities across the country often face challenges. In Portland, Oregon, a nonprofit group, Cedar Sinai, struggled to gather the financing needed to buy and preserve a 235-unit senior housing complex. Wells Fargo helped meet the need. We structured a multimillion-dollar financing plan for the nonprofit to buy and preserve the building and protect residents from potential rent hikes.”[61]
- Foundations and pension funds were the least likely to publicly report nonfinancial performance in their annual reports, and they reported it in the form of anecdotal success stories. Of the annual reports we surveyed, the Calvert Foundation was the only foundation that reported impact data, stating that its investments have resulted in 2,397 homes built or rehabilitated.[62]
- Investment firms generally highlight nonfinancial performance by describing screening and selection processes and the characteristics of underlying portfolio companies, but not outputs or outcomes.

61 Wells Fargo 2009 Annual Report, available at https://www.wellsfargo.com/downloads/pdf/invest_relations/wf2009annualreport.pdf .

62 Calvert Foundation, 2008 Annual Report, available at www.calvertfoundation.org/downloads/annual_reports/2008%20Annual%20Report.pdf.

Perhaps most surprising was that the majority of annual reports failed to discuss nonfinancial performance at all. As a proxy for nonfinancial return, many community impact investors report the total dollars invested and/or the number of loans provided to the industry as a way of expressing impact, and many annual reports categorize investments by sector such as housing, workforce development, and education. The small minority of investors that report outputs used metrics for jobs created or maintained and housing units created. Anecdotal reporting was by far the most prevalent type of nonfinancial performance disclosure, although the level of robustness anecdotal reporting provides when measuring impact remains unclear. As one interview subject related, "On the spectrum from social to financial return, it was clear that, on the social side, we were using stories and anecdotes and there was no way to differentiate between orders of magnitude."

In addition to reviewing annual reports, we surveyed investors regarding nonfinancial performance measurement. The survey demonstrated that, where investors do measure nonfinancial return, they use a wide range of methods and metrics, including jobs created, the gender and race of executives and company owners, company and worker location in an LMI community, housing units and other projects financed, child care and education slots created, environmental risks and benefits mitigated or supported, regulatory compliance, employee training and education, job quality, and sustainability practices. Interestingly, survey respondents indicated that a key driver of nonfinancial performance measurement is accountability, saying in effect that they measure and report nonfinancial returns because they are generally answerable for their performance. Most survey respondents were explicitly accountable to stakeholders, including clients (investors), sponsoring program officers, social investment committees, governing boards, senior executives, the community at large, funders, employees, government, and shareholders.

**What is high-quality performance measurement and reporting?**

The community impact investment industry can look to the traditional finance sector for examples of best reporting practices. The Global Investment Performance Standards (GIPS), which underpin the traditional investment management industry, specify that quality measurement and disclosure at least include the following: [63]

- Longitudinal data to reflect performance over time;
- Comparison to a baseline and external benchmarks;
- Independent third-party verification;
- Disclosure of calculation methodologies and definitions; and
- Timely release and update of information

63 The GIPS standards are a set of standardized, industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients, administered by the CFA Institute (available at www.gipsstandards.org).

*Table 1: Financial and Nonfinancial Disclosure*

| | Financial performance disclosure by traditional investment industry (GIPS Disclosure Requirements) | Nonfinancial performance disclosure by community impact investment industry |
|---|---|---|
| Time period | Longitudinal data | Usually point-in-time (i.e., one period) |
| Benchmarking | Financial performance data is benchmarked against the market and peers | No benchmarking, often because no benchmark exists |
| Verification | Third-party verification of all data | Only some investors use third-party verification |
| Methodology | Disclosure of calculation methodologies and definition | Rarely disclosed |
| Reporting | Timely release and update of information | When required by stakeholders (e.g., CDFI Fund), but typically not publicly, and not voluntarily |

As Table 1 shows, the community impact investing industry has a long way to go toward meeting the standards of quality reporting in traditional markets. At least one sector of the investment industry – corporate governance and shareholder engagement – already measures nonfinancial performance robustly, and this practice of measurement has catalyzed significant growth. In corporate governance, global standards and the market for active share ownership emerged primarily as a result of data and performance measurement originating from proxy-service firms including the Investor Responsibility Research Center and Institutional Shareholder Services, governance ratings firms such as GovernanceMetrics International and Davis Global Advisors, and the coverage of corporate governance issues by the major credit agencies including S&P, Moody's, and Fitch.[64] Moreover, the International Corporate Governance Network (ICGN)[65] recently approved a set of best practices for disclosure of nonfinancial performance. Intended to further raise standards of corporate governance globally, the best practices specify that reporting ought to be:

- Genuinely informative and forward-looking when this will enhance understanding;
- Material, relevant, and timely;

64 James Hawley and Andrew Williams, "Shifting Ground: Emerging Global Corporate-Governance Standards and the Rise of Fiduciary Capitalism," Environment and Planning A 37 (11) (2005): 1995-2013.

65 ICGN was created in 1995 as a global membership organization of primarily institutional investors to raise corporate governance standards worldwide. ICGN's members represent funds under management of around $9.5 trillion (www.icgn.org).

- Accessible and appropriately integrated with other information that enables investors to gain a whole picture of a company;
- Linked to strategy and easily comparable using key performance indicators;
- Presented using objective or evidence-based metrics; and
- Strengthened where possible by independent assurance.

### *3.2 Nonfinancial Performance Measurement Tools*

This section provides an overview of eight tools for measuring impact. Each has a significant presence in the industry, whether by creating a template and providing a platform for community impact investors to self-report nonfinancial returns, or by providing third-party nonfinancial performance measurement advisory services and reporting. We selected these tools specifically because of their applicability to the scope of our research – namely, that community impact investors use them concretely. Further, these tools aggregate or publish data that investors and/or other stakeholders can use to benchmark nonfinancial performance. The list is not exhaustive, but it is substantially representative of the actual measurement of nonfinancial performance in community impact investing. The tools provide varying levels of customization and service, at different costs to investors.

This overview consists of a short description of each tool's development and methodology, the metrics it reports, how users collect and report the data, and the categories of investors using the tool. We compiled the information for these profiles using each tool's respective website and literature, stakeholder interviews, and the report "Catalog of Approaches to Impact Measurement – Assessing Social Impact in Private Ventures" by Sara Olsen and Brett Galimidi.[66] Table 2 below summarizes the key characteristics of the tools.

66 Sara Olsen and Brett Galimidi, "Catalog of Approaches to Impact Measurement – Assessing Social Impact in Private Ventures." (San Francisco: Social Venture Technology Group, May 2008).

*Table 2: Nonfinancial Performance Measurement Tools*

| Measurement tool | Cost to end user | Metrics | Benchmarking | Output | Data collection | End user |
|---|---|---|---|---|---|---|
| **B Impact Rating System** | No Cost | Standardized | Underlying investments (registered B corporations) are benchmarked against each other | Financial and nonfinancial performance attributable to B corporations | Data are collected in survey form and analyzed by a third party | Banks and venture capital funds (currently) |
| **CDFI Data Project** | No Cost | Standardized | Reports overall impact of CDFIs – no attributable benchmarking | Aggregated data include financial and nonfinancial performance | Data are collected in survey form and analyzed by a third party | CDFIs and investors in CDFIs |
| **Community Investment Impact System** | No Cost | Standardized | Benchmarked against other CDFIs and CDEs | Infrequent release of aggregate financial and nonfinancial data | Data are collected in survey form and analyzed by a third party | CDFI Fund |
| **Global Impact Investing Rating System** | Low Cost | Somewhat customized | Rated investments are benchmarked against each other | Publicly available rating, attributable to underlying investment. Nonfinancial data only | Data are collected in survey form and analyzed by a third party | Pilot investors (current) |
| **Pacific Community Ventures** | High Cost | Customized | Benchmarking of performance to broader market trends, absent the investor's intervention | Detailed nonfinancial performance report to client | Third-party collection of survey responses. Third-party analysis | Institutional private equity investors, foundations |
| **NCIF Social Performance Metrics** | No Cost | Standardized | Benchmarking across "CDBIs". Performance is attributable | Public reporting. Detailed summary and individual reports. | Third-party collection of public data and survey responses. Third-party analysis | Investors in depository CDFIs |
| **CDFI Assessment and Ratings System (CARS)** | Moderate Cost | Highly customized nonfinancial metrics | Benchmarked against other CARS-rated organizations | Detailed reports available by subscription to investors. Financial and nonfinancial performance | Third-party data collection, via survey and audit. Third-party analysis | Investors in CDFIs |
| **CDVCA Measuring Impacts Toolkit** | No Cost | Standardized | Reports overall impact of CDVC funds with no attributable information | Aggregated financial and nonfinancial data | Data collection by survey. Third-party analysis | Community development venture capitalists |

## B Impact Rating System

The B Impact Ratings System (BIRS) is a free, online tool from B Lab that measures businesses' impact on employees, the environment, community, suppliers, and consumers, as well as their accountability to stakeholders. B Lab developed BIRS in 2007 with the feedback of entrepreneurs, investors, and educators. The metrics and weightings in BIRS are governed by the Standards Advisory Council, an independent body of nine experts in social

and environmental sustainability.[67] BIRS is intended to help B Lab to certify B corporations (corporations that are committed to meeting BIRS standards) and investors to select high-impact investments, policymakers to drive tax or procurement decisions, and business associations to educate their members.[68] The report rates a company according to those standards and how well it institutionalizes employee, community, and environmental welfare in its governance and structure. The assessment is customized for the company undertaking it. According to B Lab representatives, investors currently using BIRS to evaluate nonfinancial impact include banks and venture capital funds, but they expect CDFIs, pension funds, microfinance institutions, and equity funds outside the United States to begin using it soon.

**CDFI Data Project**

The CDFI Data Project (CDP) is a collaborative effort by key trade associations including the Opportunity Finance Network, the Community Development Venture Capital Alliance, and the Association for Enterprise Opportunity to collect and analyze CDFI data that include the sector's community impacts.[69] The goal of the CDP is to ensure access and use of data by CDFIs and CDFI investors to improve practice and attract resources to the CDFI field. The data set includes approximately 100 data points on operations, financing, capitalization, and impact, focusing primarily on operational data but including demographic and socioeconomic borrower and investment recipient information.[70] Although 508 CDFIs reported to the CDP in 2007, the data were disclosed only at the aggregate and sub-sectoral level, with no attributable institution-level information.[71] CDFIs can elect to have the CDP list their names alongside their data , but at present none of the CDFIs take advantage of the opportunity, at least in the reporting of community impacts.

**Community Investment Impact System (CIIS)**

The CDFI Fund uses the Community Investment Impact System (CIIS) to track and measure the financial and nonfinancial impact of CDFIs and CDEs receiving CDFI Fund awards. The CIIS, designed to be the primary data source for the CDFI industry, compiles data for two reports: an institutional-level report (ILR) and the industry's only standardized transaction-level report (TLR).[72] The TLR includes nearly 200 data points covering each individual loan and investment, although submitting many of those data points is optional. The ILR captures organizational data that include background information on the submitting institutions. Any certified CDFI can voluntarily submit a TLR. The CDFI Fund currently

67 http://www.bcorporation.net.
68 Ibid.
69 Opportunity Finance Network website, http://www.opportunityfinance.net/.
70 Ibid.
71 CDFI Data Project, Community Development Financial Institutions.
72 Heidi Kaplan, "First Mover: The CDFI Fund's CIIS Database Holds Promise to Create Substantial Data Repository for Community Development Investments," Community Development Investment Review 3 (2) (2007), 51.

shares CIIS data with two additional federal agencies and two private parties conducting contracted services for the CDFI Fund. CIIS community impact metrics include jobs created, affordable housing units supported, and the capacity of community facilities financed.[73]

**Global Impact Investing Rating System (GIIRS)**

The Global Impact Investing Rating System (GIIRS) is currently under development by B Lab in partnership with a steering committee of the Global Impact Investing Network.[74] The GIIRS is intended to "assess the social and environmental impact (but not the financial performance) of companies and funds using a ratings methodology analogous to Morningstar investment ratings or S&P credit risk ratings."[75] Although this system looks at global impact investing, we included it in the tools survey because of its direct implications for domestic community impact investing. It is intended for use by both institutional investors and investment intermediaries to evaluate, screen, manage, and communicate the social impact of their investments. According to the GIIRS website, the GIIRS includes surveys that differ by geography, size of company, and industry. Each survey includes approximately 160 questions divided into five categories: leadership, employees, environment, community, and products & services. The GIIRS will make its ratings system (including all survey questions and the weightings methodology) transparent to the public.[76]

**Pacific Community Ventures**

Pacific Community Ventures (PCV), provides an impact measurement tool and third-party advisory service designed to provide detailed employment and job quality data for each portfolio company to which financially driven private equity investors are exposed, aggregated at the portfolio level. The analysis is implemented as an in-depth annual or biannual report based on social metrics that the investor and PCV agree to collect. PCV provides a detailed report on nonfinancial performance to clients, including most notably the California Public Employees Retirement System (CalPERS) and foundations including the Northwest Area Foundation and the Annie E. Casey Foundation. PCV uses metrics including jobs created, employee benefits, low-income workers supported, and female and minority ownership and management at underlying portfolio companies. PCV's report to CalPERS is publicly available and includes detailed methodological information. The report also benchmarks CalPERS' performance to the appropriate state and national workforce data.

73 www.cdfifund.gov.

74 Founding GIIN members include the Acumen Fund, The Annie E. Casey Foundation, The Bill and Melinda Gates Foundation, Calvert Foundation, Capricorn Investment Group, Citigroup, Deutsche Bank, Equilibrium Capital, Generation Investment Management, Gray Ghost Ventures, IGNIA, J.P. Morgan, Lundin for Africa, Lunt Family Office (Armonia), Omidyar Network, Prudential, The Rockefeller Foundation, Root Capital, Shorebank/NCIF, Trans-Century, Triodos Investment Management, and Wolfensohn & Company (www.globalimpactinvestingnetwork.org, Accessed May 1, 2010).

75 www. giirs.org, Accessed May 1, 2010

76 Ibid.

### NCIF Social Performance Metrics

The National Community Investment Fund (NCIF) developed its Social Performance Metrics tool to measure the social impact of banks and thrifts working in underserved populations, also called community development banking institutions (CDBIs).[77] The tool uses a number of industry-specific metrics, including publicly available census data, branch location data, and mortgage loan data. For example, NCIF's development lending intensity metric assesses the percentage of an institution's home loan originations and purchases that are located in LMI census tracts. The goal is to provide investors with information that will help them make targeted investments based on geographic need. Accompanying these metrics is a qualitative survey that probes CDBI service area, mission, and partners. The database tool is located on the NCIF website and is available to the public.[78]

### CDFI Assessment and Rating System (CARS)

The CDFI Assessment and Rating System (CARS), a project of the Opportunity Finance Network, is designed as a comprehensive third-party assessment of CDFI loan fund nonfinancial and financial performance. The purpose of CARS is to "increase the amount of capital available [CDFIs] for community development purposes and to promote CDFI performance as a primary criterion determining the flow of capital through these institutions to economically disadvantaged people." CARS provides ratings for both financial strength and impact performance based on a five-year track record. Information is collected through on-site examinations that include in-depth interviews with management and board members, analysis of financial and programmatic information, and thorough review of loan files and risk management systems. Although high-performing CDFIs often publish their rating score, the comprehensive results of their analyses are available only by subscription for CDFI investors. Approximately 55 CDFIs receive a CARS rating, and 35 impact investors have subscribed to the CARS reports.[79]

### Community Development Venture Capital Alliance's Measuring Impacts Toolkit (MIT)

The Community Development Venture Capital Alliance's Measuring Impacts Toolkit (MIT) is specifically targeted to venture capital impact investors. The MIT is a Microsoft Excel–based survey with more than 70 questions at its core. Additional survey modules collect data on benefits, wealth building, and training, and include over an additional 100 data points according to company type. The core social impact data, collected for each company in a fund's portfolio, cover three major impact areas: employment, wages and career ladders, and benefits. The module survey data cover impacts on community and the

77 Saurabh Narain and Joseph Schmidt, "NCIF Social Performance Metrics: Increasing the Flow of Investments in Distressed Neighborhoods through Community Development Banking Institutions," Community Development Investment Review 5 (2) (2009), 65.

78 www.ncif.org.

79 www.carsratingsystem.net/ratings, accessed May 1, 2010.

environment.[80] The data are reported in the aggregate in order to preserve the portfolio companies' anonymity; however, the MIT is designed to be an inexpensive "off-the-shelf" product that individual venture capital funds can purchase. There is no provision for entering individual funds' data into a central system for sector-wide reporting.

### *3.3 Barriers to Measuring Nonfinancial Performance*

The tools and practices we highlighted above represent a sample of current efforts, but it remains the case that very few investors either rigorously measure or report nonfinancial returns. This phenomenon is not new to the industry and has been the subject of discussion among stakeholders for some time. The following section highlights the barriers to a more robust regime of industry-wide performance measurement, first briefly describing nine distinct barriers identified in the literature and then explaining how the nine distill into three major impediments to nonfinancial performance measurement that the industry must confront.

#### Nine Barriers Evident in the Literature

The literature enumerates nine specific barriers to industry-wide nonfinancial performance measurement. These barriers underscore the extent to which diversity characterizes the community impact investing industry. A brief description of each of the nine barriers follows.

1. *Diversity of investor preferences and nonfinancial objectives.*
   Each investor – be it a bank, a public sector pension fund, an insurance company, a foundation, or a faith-based organization – places a different value on nonfinancial return.[81] Further, their investments in different sectors reflect their various missions and visions (such as investments in job creation, support for emerging domestic markets, or construction of affordable housing). These differences are a significant barrier to any attempt to distill the interests, preferences, and aspirations of all investors into a single industry-wide nonfinancial performance measurement practice.

2. *Diversity of measurement methods.*
   The increasing number of measurement tools points to a state of uncoordinated innovation in which duplicate activity and confusion over language result in inefficiency.[82] Investors feel overwhelmed or misinformed by the lack of consensus around what constitutes a robust or actionable methodology.

80 CDVCA Measuring Impacts Toolkit v1.1, 2005.
81 Hagerman and Ratcliffe, "Increasing Access to Capital," 48.
82 Kaplan, "First Mover," 58.

3. *Diversity of products and underlying investments.*
   The variety of products through which to invest – from loan pools to private equity funds – and investment targets – from women- or minority-owned businesses to affordable housing – presents significantly different challenges to measuring performance.[83]

4. *High cost and low capacity.*
   Nonfinancial performance measurement can be costly, time consuming, and peripheral to the core competencies and capacities of investors.[84]

5. *Lack of data or information about the provider.*
   There is no consistent and detailed information on the performance of community impact investing intermediaries, particularly outside of the CDFI Fund, which also lacks transparency.[85]

6. *Lack of data or information about the product.*
   Data on underlying community impact investments and the markets in which capital is being deployed are often fragmented, nonstandardized, and not widely accessible.[86]

7. *Lack of infrastructure.*
   The network of markets, accountants, auditors, and standards needed to track and verify nonfinancial performance as rigorously as financial performance lags; social program evaluation lacks maturity; and the current approaches to nonfinancial measurement continue to be people- and expertise-dependent, lacking the systemization to ensure basic levels of reproducible data, data integrity, and comparability.[87]

8. *Insufficient demand.*
   For many investors, the costs outweigh the benefits of both measuring and reporting nonfinancial returns. According to Lisa Hagerman and Janneke Ratcliffe, demand for nonfinancial performance measurement is something of a "chicken and egg dilemma," in that "improved and more widespread social impact measurement will only develop to the extent investors require it, [even as] investor interest hinges on developing a more clearly defined and measurable investment theme."[88]

83 Hagerman, "More than a Profit?," 5.
84 Hagerman and Ratcliffe, "Increasing Access to Capital," 49.
85 Kaplan, "First Mover," 56. See also, Ellen Seidman, "Bridging the Information Gap between Capital Markets Investors and CDFIs," Community Development Investment Review 2 (2) (2006).
86 Cynthia Gair, "SROI Act II: A Call to Action for Next Generation SROI." (San Francisco: REDF, October 2009).
87 Freireich and Fulton, "Investing." See also, Gair, "SROI Act II."
88 Hagerman and Ratcliffe, "Increasing Access to Capital," 57.

9. *Business practices.*
   Stakeholders often view the information necessary for measuring nonfinancial performance as private or proprietary.[89] Although legal or technical solutions may address privacy concerns, some investors are suspicious of providing data to external parties that they are unaccustomed to sharing.[90]

## Three Key Barriers in Practice

These nine barriers create problems of varying magnitude for investors; some are merely nuisances, whereas others create a very real sense of frustration and hopelessness. Stakeholder interviews suggest that, in practice, they distill into three key impediments: diverse and ambiguous investor preferences; broadly inadequate tools and practices; and a lack of accountability for nonfinancial return.

*Diverse and Ambiguous Investor Preferences*

As we have discussed throughout this paper, the nonfinancial goals and objectives of investors differ substantially.[91] Investor preferences that are driven by different structural, operational, cultural, and stakeholder priorities result in very different demands for nonfinancial performance measurement and reporting. The problem of ambiguity stems from the difficulty of expressing or quantifying the value that investors assign to nonfinancial returns, either because the value is so intrinsic that it may be difficult to fully articulate, or simply because the value is intangible or immeasurable. Although any attempt to fully describe the nonfinancial preferences of investors is inherently speculative, objectives beyond measurable outputs (such as jobs created or properties financed) include brand differentiation, a desire to influence the behavior of the market, addressing perceived market failures, efforts to achieve political or values-oriented goals, and the need to satisfy regulatory requirements. Diversity and ambiguity in investor nonfinancial objectives inherently limit the pool of prospective investors who might use any single measurement tool or practice.

*Inadequate Tools and Practices*

Numerous structural and operational limitations render nonfinancial performance measurement tools and practices inadequate for many investors. These limitations might include insufficient or unverifiable data, infrastructure and methodological barriers, inefficient or unsuitable processes and systems, and unaffordable third-party or even off-the-shelf tools.[92] Unless investors believe that a tool or practice is truly cost-effective – cost measured in time and resources, and effectiveness measured in the quality, relevance, and value of the informa-

89 Ibid, 61.

90 Glenn Yago, Betsy Zeidman, and Jill Manning, "Hunting for Data Sources: How Improving Data Can Increase Capital for Emerging Domestic Markets," Community Development Investment Review 3 (2) (2007).

91 Hagerman, "More than a Profit?," 5.

92 Kaplan, "First Mover, 58"; see also Hagerman, "More than a Profit," 30; and Hagerman and Ratcliffe, "Increasing Access to Capital," 61.

tion it provides to key stakeholders – they are unlikely to devote whatever effort is necessary to supporting nonfinancial performance measurement. The fact remains that measuring nonfinancial performance is simply very difficult. Although tools and practices will become more suitable and effective over time, it is likely to take many years to address underlying impediments.

*Lack of Accountability for Nonfinancial Return*

Most community impact investors are simply not required to report nonfinancial returns, reducing the likelihood that they will devote time and resources to measurement, and reducing their demand for tools and practices. For example, even the largest investor in the sector – the CDFI Fund – requires that CDFIs report data only when receiving technical or financial assistance or NMTC allocations. Even then, CDFIs must respond only to a relatively narrow set of eight community impact survey questions. In any one year, just one-fifth of CDFIs are mandated to report to the CDFI Fund.[93] Although CDFIs more willingly provide data to industry-driven initiatives like the CDFI Data Project, the data are presented only in the aggregate and are not attributable.

The lack of accountability for nonfinancial returns, and by extension the lack of demand for nonfinancial performance measurement, means that few industry resources are deployed to develop and enhance practices, with one or two notable exceptions. When accountability is clear, and creates an incentive to measure nonfinancial performance, measurement and reporting are likely to be prevalent and robust. For example, because CalPERS demands a detailed annual report on the "auxiliary benefits" of the California Initiative, the 30 funds that manage money for the program (and the 200 companies in which they invest) are subject to some of the most rigorous nonfinancial reporting requirements in the sector. Similarly, the impact investors that responded to the more detailed survey we discussed above have two things in common: they report nonfinancial returns, and they do so in part because they believe that they are accountable for the nonfinancial returns that they measure.

Other factors contribute to limited accountability. First, accountability is itself a function of other variables. According to one interview subject, "accountability is a good framework for discussing what metrics are needed, but having the right balance of metrics is important because having too many, or a system that is too complicated, reduces accuracy and cooperation." In other words, investors will be more accountable for nonfinancial performance if the tools that they use to measure performance are well suited to the task. Second, accountability differs significantly by investor type, particularly for those deploying their own capital (foundations and individuals) and those entrusted with investing the money of others (depository and nondepository institutions and government). Finally, many investors also consider accountability to be a risk. For example, reactions to the possibility of linking CDFI Fund data to individual entities have been mixed. As one interview subject confirmed, "Some see it as an opportunity, others as a threat. How do we present the information objectively without offending key stakeholders?"

93 Kaplan, "First Mover," 53.

### Moving Forward

The community impact investing industry is substantial. It includes a large number of investors making thousands of diverse investments, valued at tens of billions of dollars, for both financial and nonfinancial return. Yet a surprising number of community impact investors either do not measure nonfinancial performance robustly or do not disclose their findings. In order to advance the field, the industry first needs to revisit why nonfinancial performance measurement is critical to scaling the sector. In order to make a case for nonfinancial performance measurement, we need an understanding of investor preferences that addresses the barriers we described above and considers ways to motivate industry-wide action.

## Part IV: The Case for Nonfinancial Performance Measurement

Effective nonfinancial performance measurement is a key component of the impact investing industry's growth and, as such, an important part of unlocking an estimated $500 billion in potential capital.[94] Tools and practices continue to surface, and because investors have very different preferences for nonfinancial return and nonfinancial performance measurement, innovation will likely consist of a continued proliferation of approaches. No matter how diffuse the way forward, however, it is essential to make a stronger and more cohesive case for nonfinancial performance measurement in general.

Our research underscores four key questions that investors and industry stakeholders are currently asking, and need to address, in order to advance the field.

1. Does nonfinancial performance measurement really matter for investors?
2. If it does matter, is nonfinancial performance measurement even possible?
3. If nonfinancial performance is possible to measure, what form should it take?
4. How will nonfinancial performance measurement increase community impact investing?

This section discusses each question in order, highlighting investor behavior as a determinant of the field's development and discussing the role of two crucial means of effecting change: innovation and accountability. The section also introduces a new method for characterizing investors, asserting that each has a willingness to pay for nonfinancial performance, which is an indication of the value an investor assigns to nonfinancial return, and a willingness to disclose, which is an indication of the extent to which an investor is accountable for, and reports, community impacts. Insight into these two characteristics provides a number of important general observations about the role and future direction of nonfinancial performance measurement.

94 The Monitor Institute estimates that impact investing more broadly – the active deployment of capital for social and environmental impact, domestically and internationally – could grow in the next 5–10 years to represent 1 percent of investment assets under management or $500 billion (Freireich and Fulton, "Investing"), 57.

### *4.1 Does Nonfinancial Performance Measurement Really Matter for Investors?*

A number of industry stakeholders remain agnostic about nonfinancial performance measurement. Federal Reserve Chairman Ben Bernanke, however, is not one of them. Speaking in 2006 about the importance of data and measurement in community finance, Bernanke argued that "It is difficult to overstate the importance of adequate and accurate information for attracting capital."[95] Nancy Andrews, President and CEO of the Low Income Investment Fund (LIIF), recently expressed a similar sentiment, writing that "impact analysis is at least as important as financial performance."[96] However, for every Chairman Bernanke and Nancy Andrews, there is an impact investor asking the questions: "What do investors want? Is it really social return, or is social return just icing on the cake?"; and "Do investors value data or measures of social impact, or just a seal of approval?"[97] Even as the prevalence of measurement as a subject of discourse underscores that nonfinancial performance measurement does matter – together with some unprecedented investments in innovation[98] – we must ask the question: "but why?" The answer is that nonfinancial performance measurement informs investor behavior and is instrumental to determining an investor's willingness to pay for nonfinancial return.

**Willingness to Pay**

Willingness to pay is a concept that provides additional insight into investors' nonfinancial performance objectives. It describes the quantity of time, effort, investment earnings, or other resources that investors are willing to exchange for a preferred value of nonfinancial return. It is similar to the current method for describing investors as either financial-first or impact-first, but it places them on a continuum instead of placing them in the two categories.[99] By locating investors on a continuum, willingness to pay better accommodates the tremendous diversity of investor nonfinancial objectives. It recognizes that an investor's preferences for nonfinancial return are discrete, and that no single investor is likely to have the exact same objectives. The magnitude of an investor's willingness to pay is informed by a wide range of inputs including strategic, operational, and cultural priorities; outside stakeholders; and the availability of actionable data. Only the investor can truly know the "value" that it places on nonfinancial return, or the "price" that it is willing to pay for that value. Table 3 illustrates some examples of these values and prices.

95 Bernanke, "By the Numbers," 3.

96 Nancy Andrews and Christopher Kramer, "Coming Out as a Human Capitalist: Community Development at the Nexus of People and Place," Community Development Investment Review 5 (3) (2009), 63.

97 Two direct quotes from interview subjects.

98 The Rockefeller Foundation, the United States Agency for International Development, Prudential Financial, and Deloitte have partnered with the nonprofit B Lab to provide $6.5 million to support the development and use of GIIRS. B Lab, "Impact Investing Partnership with USAID, Rockefeller Foundation, Deloitte, and Prudential Financial to Support Entrepreneurs in the Developing World." Press release. (Berwyn, PA: B Lab, April 26, 2010).

99 Freireich and Fulton, "Investing."32

*Table 3: The "Value" and "Price" of Nonfinancial Return*

| The 'value' of non-financial return | The 'price' investors might be willing to pay for non-financial return |
|---|---|
| • Satisfying mandated or explicit client nonfinancial objectives<br>• Meeting regulatory requirements<br>• Explicit nonfinancial outcomes (e.g. jobs created, affordable housing units financed)<br>• Brand differentiation<br>• Influencing the behavior of the market<br>• Political and values-oriented benefits<br>• Economic efficiency gains (i.e. redressing market failures or producing public goods) | • Time and cost of providing evidence against discrete objectives<br>• Management/investment effort required to earn mandated nonfinancial return<br>• Transparency and accountability<br>• Effort demonstrating compliance to regulator<br>• Below-market returns in target markets<br>• Resources devoted to building and maintaining brand<br>• Higher operating or transaction costs<br>• The costs of participating in and leading dialogue |

The idea of willingness to pay is born of current industry practices and is not intended to be controversial. On the contrary, the values and prices in Table 3 are plainly visible. A pension or investment fund must satisfy mandated client objectives and must provide evidence that it has done so. The CRA requires banks to invest in low-income communities and to demonstrate this compliance to regulators. CDFIs and other mission-driven investors have an interest in explicit community impacts, and they typically carry higher operating and transaction costs to meet these objectives.[100] Private foundations are eager to "move the needle," influencing the behavior of markets, and will consider the costs of participating in and leading industry dialogue as one component of the expense of doing so.

Investors that place the highest value on nonfinancial return will be willing to pay the most for it. For example, a foundation interested in creating housing opportunities may provide capital to an affordable property developer through a program-related loan with a concessionary cost of borrowing. Conversely, a CRA-regulated bank investing in the same affordable housing project is more likely to provide financing at a price closer to the market rate of return. Although existing literature may refer to these investors as impact first and financial first, respectively, we can also envision them at different points on the willingness to pay continuum. The New York Acquisition Fund is an example of an investment that used capital from investors with a high willingness to pay to secure financing from investors with a low or no willingness to pay. The Fund leveraged an $8 million, 0 percent interest rate loan from the public sector as a first loss fund, and $32 million in below-market foundation

100 The efficiency ratio for CDFI banks ended 2008 at 83.58 percent compared to the "all bank" median efficiency ratio of 70.91 percent. National Community Investment Fund, The CDFI Banking Sector: 2009 Annual Financial and Social Performance. (Chicago: NCIF, 2009).

PRIs as a second loss fund, to attract more than $200 million in senior debt authority from conventional lenders.[101]

For most community impact investors – including public agencies, foundations, and CRA-motivated banks – some value of nonfinancial return supplants financial return. In other words, the price these investors are willing to pay includes a tradeoff between financial and nonfinancial return. However, for other investors required to maximize financial return at all times, the value of nonfinancial return may be purely additive, creating a "total return" that is more valuable than a market return. These investors will be unwilling to pay for nonfinancial return in the form of below-market financial earnings. Such investors include the public pension funds making economically-targeted investments under the auspices of a fiduciary duty to current and future retirees.

**Nonfinancial Performance Measurement and Willingness to Pay**

Nonfinancial performance measurement is critical because, simply put, willingness to pay is partly determined by the quality of the information that investors use to make decisions about financial and nonfinancial tradeoffs.[102] In other words, investor behavior is shaped by the very practice of nonfinancial performance measurement. For one community development venture capital fund, CEI Ventures, nonfinancial performance measurement is said to affect "fund formation, investment decision making, the provision and allocation of resources, [and] messaging, and is vital to achieving goals."[103]

To be sure, the question "does nonfinancial performance measurement really matter for investors?" is somewhat extraneous. Investors must decide independently if nonfinancial performance matters. To the extent that it does, high-quality data and information are essential.

### *4.2 Can Nonfinancial Performance Actually Be Measured?*

There is still the problem of seemingly intractable barriers to measurement, including the diversity and ambiguity of investor preferences, insufficient infrastructure, and poor data. In practice, however, nonfinancial performance is already being measured, is already informing investor behavior, and will continue to improve as a result of innovation.

**Addressing the Barriers to Nonfinancial Performance Measurement through Innovation**

Despite the challenges, there are steps that industry and government can take, and are already taking, to ensure that the measurement of nonfinancial returns becomes more effective and widespread. The efforts of the recently created Global Impact Investing Network

101 Lisa Richter, "California Community Development Finance Meeting: Strategies to Respond to the Economic Crisis, Issues Backgrounder." San Francisco: Federal Reserve Bank of San Francisco Working Paper, November 2009).

102 Hagerman, "More than a Profit?," 33.

103 Dawn Marie Estlow Stillings, "Measuring the Social & Environmental Impacts of Community Based Investing – More than Data Points: A Comprehensive Process and its Challenges." (Presentation to Public Pension Funds & Urban Revitalization Initiative, December 11, 2007.)

(GIIN) and the closely related Investment Reporting and Investment Standards (IRIS) are especially notable. Founded in 2007 by the Rockefeller Foundation and a group of other impact investors,[104] the 40-member GIIN specifies its purpose as "identifying and addressing the systemic barriers that hinder the impact investing industry's efficiency and effectiveness."[105] The IRIS project, which evolved out of original efforts begun by the Rockefeller Foundation, the Acumen Fund, and B Lab, and is now is administered by GIIN, represents the network's efforts to create a taxonomy for impact investing and a framework for reporting and evaluating nonfinancial returns. IRIS hopes to provide a standard set of metrics that can be compared and rated across the universe of impact investments.[106]

GIIN is also behind the development of the GIIRS rating system, which advocates believe through its very existence will create more demand for nonfinancial performance measurement. As a supporter of GIIRS, stated:

> *As we provide tools with more credibility, that are more cost effective and transparent, it will become more difficult for investors to willfully not use social performance tools. At the moment, with the industry more fragmented, it is easier to understand why investors do not measure social performance. But there will be fewer opportunities not to hold yourself accountable moving forward.*[107]

A more targeted, discrete form of industry-driven innovation is the Center for Financial Services Innovation's (CFSI) work on a new scorecard measuring the "customer impact" of financial services companies targeting the "underbanked." CFSI will ultimately promote the scorecard to other investors in need of similar nonfinancial performance information.[108] Moreover, many of the tools we profile in this report are improving daily. PVC is a case in point, working to expand its third-party impact evaluation services to a number of new categories of socially oriented venture capital funds, as well as to other asset classes.

SVT Group, a widely used social evaluator, addresses diverse investor preferences by approaching nonfinancial return as a management discipline. Rather than setting out to measure specific units of return, SVT Group helps stakeholders evaluate the process by which they achieve impact. In this vein, SVT Group sees nonfinancial performance not as the endgame of, but rather the path to, community impact. SVT Group has developed the SROI Toolkit to help investors and corporations manage impact rather than simply measure it.

Other industry actors address the barriers through policy innovation. For example,

104 Founding GIIN members include the Acumen Fund, The Annie E. Casey Foundation, The Bill and Melinda Gates Foundation, Calvert Foundation, Capricorn Investment Group, Citigroup, Deutsche Bank, Equilibrium Capital, Generation Investment Management, Gray Ghost Ventures, IGNIA, J.P. Morgan, Lundin for Africa, Lunt Family Office (Armonia), Omidyar Network, Prudential, The Rockefeller Foundation, Root Capital, Shorebank/NCIF, Trans-Century, Triodos Investment Management, and Wolfensohn & Company (www.globalimpactinvestingnetwork.org).

105 www.globalimpactinvestingnetwork.com.

106 www.iris-standards.org.

107 Direct quote from interview

108 Interview with Arjan Shutte, CORE Innovation Capital, April 5, 2010.

Opportunity Finance Network has advocated for the creation of an "innovation bank" within the CDFI Fund, a research and development program that could serve as a logical source of funding for improving nonfinancial performance measurement.[109] B Lab's ongoing work to promote state laws accommodating B corporations is also likely to improve the nonfinancial performance measurement practices of the investors that deploy capital to these new types of companies, in so doing generating and incentivizing additional accountability.[110]

The federal government also plays a role in promoting more effective measurement through innovation. The CDFI Fund regularly updates the CIIS system technology and user accessibility.[111] In addition, on May 14, 2010, the CDFI Fund invited public comment on continuing reforms, including in the areas of minimizing the cost and burden of data collection and CDFI/CDE compliance, and the quality, utility, and clarity of the information being collected.[112] Further, the CRA has recently come under review by its regulators, which include the Federal Reserve's Board of Governors, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, and could be subject to changes that affect how depository agencies make community impact investments and how they measure and report on those investments.[113]

Because of innovations like these, nonfinancial performance measurement is informing investor behavior like never before. The NCIF Social Performance Metrics framework is one tool that has helped drive investment to high-performing community impact investors. According to NCIF, several community development banking institutions are already demonstrating their "willingness to report more impact information to investors since these institutions have received greater funding from the socially responsible investor community."[114] Bank of America Merrill Lynch, which measures the nonfinancial performance of its Capital Access Funds (CAF), a private equity fund-of-funds investing in underserved markets for clients including CalPERS, the California State Teachers' Retirement System, and the New York State Common Retirement Fund, states that "CAF reviews its efficiency in realizing social impact on an ongoing basis to ensure that its investing efforts identify the impact areas that are of most interest to CAF as it considers fund investments." And Federal Reserve Chairman Ben Bernanke recently highlighted the CARS rating system as potentially having "the double benefit of attracting more funds into community development and helping to ensure that those funds are effectively used."[115]

109 Opportunity Finance Network, "Top Policy Recommendations for Opportunity Finance," www.nextamericanopportunity.org/toprecommendations.

110 B Lab, Certified B Corporation Public Policy homepage, www.bcorporation.net/publicpolicy.

111 Kaplan, "First Mover," 54.

112 www.cdfifund.gov.

113 Board of Governors of the Federal Reserve, "Agencies Announce Public Hearings on Community Reinvestment Act Regulations." Press release (June 17, 2010), available at www.federalreserve.gov/newsevents/press/bcreg/20100617b.htm.

114 Narain and Schmidt, "NCIF," 73.

115 Bernanke, "By the Numbers," 4.

Although barriers, including poor data and measurement infrastructure, will continue to hamper the quality of nonfinancial performance measurement tools, they do not render the practice altogether futile. On the contrary, investors are already leveraging business-relevant insights from nonfinancial performance measurement, and will benefit from further innovation.

### *4.3 What Form Should Nonfinancial Performance Measurement Take?*

Innovation occurs at all levels and comes from a wide range of stakeholders--from the practices of a single community impact investor to the broad initiatives implemented voluntarily by industry or imposed by regulation. Not surprisingly, this diffuse form of innovation reflects the diverse nature of the community impact investment industry and the variety of investor preferences for nonfinancial return.

Put another way, there is a proliferation of nonfinancial performance measurement tools and practices precisely because investors demand it. It is not surprising that existing tools are insufficient, but this is not an insurmountable obstacle. For now, however, there is no silver bullet for measuring nonfinancial performance – no single metric, tool, or practice that suits every investor. Such a silver bullet is unlikely to emerge in the immediate future, but even so, the way to pursue greater standardization is to accommodate the ways in which investors express their preferences for community impact.

#### The Investor-Centered Perspective

Investors drive demand for nonfinancial performance measurement as both the consumers and the producers of community impact data. Innovation in nonfinancial performance measurement is therefore likely to be more catalytic if it reflects and responds to investors' varied nonfinancial objectives, structures, and investment strategies. Innovation that focuses first on the development of tools and practices, and expects investors to adjust their behavior accordingly, is likely to see greater resistance.

Although an investor-centered perspective implies that innovation will be diffuse and that the silver bullet is more likely to be an arsenal of measurement tools, in practice the metrics that investors use and report on are often similar within a sector. Categories of investors that invest in particular asset classes, that are subject to similar regulatory requirements, or that have similar nonfinancial objectives tend to coalesce around the same data. For example, most banks subject to the CRA, including three-quarters of those we reviewed for this project, report the volume of loans provided to low-income communities in annual reports. CDFI loan fund disclosures highlight the type and quantity of community facilities financed or constructed. And for investors working to create "quality jobs," health and retirement benefits for the workers their investments support are important measures of success.

The development of IRIS demonstrates both the overall complexity of the community impact investing sector and the progress toward a more consolidated system of nonfinancial performance evaluation. The first version of the IRIS taxonomy includes more than

170 operational, financial, and descriptor metrics applicable to all investors. Yet once IRIS drills down to the investors' area of interest, the number of metrics falls substantially – for example, to 38 in community development finance, 43 in education, and 40 in healthcare.[116]

Shared investor preferences and a strong understanding of willingness to pay are important anchors for the future development of nonfinancial performance measurement. However, the investor-centered approach is also tied directly to accountability. To the extent that investors measure and report nonfinancial performance, they often do so because they are required to. As one interview subject conjectured: "It is perfectly reasonable behavior of organizations not to want to collect more information. If they collect it, what will they get? What's the upside?" And as another confirmed, "if the requirement to provide data is voluntary, the tool or practice will have limited value."

**Willingness to Disclose**

Willingness to disclose is another concept that we can use to characterize investors, one that relates directly to accountability. Willingness to disclose is a measure of the quantity and quality of nonfinancial return reporting that investors are willing to provide to the stakeholders to which they are accountable. The magnitude of an investor's willingness to disclose is shaped both by internal preferences – the value that an investor places on information and transparency – and by external forces, including the extent to which stakeholders request or demand disclosure. A larger magnitude implies a higher quality of reporting that is likely to be more akin to practices in the traditional investment management industry we discussed earlier, where measurement is longitudinal, performance is benchmarked and independently verified, and evaluation methodology is transparent.

**Insights into Nonfinancial Performance Measurement Using Willingness to Disclose and Willingness to Pay**

As with willingness to pay, willingness to disclose falls on a continuum. By plotting the willingness to pay and willingness to disclose continua simultaneously, our research provides some important general insights into the drivers of innovation and accountability and, by extension, the direction that nonfinancial performance measurement will likely take.

For the purposes of this research, we consider the locations on the two continua of seven categories of community impact investors:

- ***CDFI recipients of CDFI Fund assistance*** are mission-driven and created for the explicit purpose of investing in underserved communities. CDFIs have a high willingness to pay for nonfinancial return and, because they receive government funds and must report to the CIIS, they have a high willingness to disclose nonfinancial return to the stakeholders to which they are accountable.

116 www.iris-standards.org. The first version includes 105 operational metrics, 36 financial metrics, and 33 descriptor metrics.

- ***Most other CDFIs*** also have a high willingness to pay but, without the requirement to report data to the CDFI Fund, lack the incentive to measure nonfinancial performance and have a lower willingness to disclose. Only one-fifth of CDFIs report to the CDFI fund and even fewer – 56 out of more than 1,000 – work with the industry-driven initiative providing the most attributable community impact information, CARS.[117]
- ***Private foundations*** are also mission-driven and, like CDFIs, are mandated to invest in a way that advances that mission, at least through program-related investments, where they typically accept a concessionary rate of financial return. Thus they have a high willingness to pay. But as our review of annual reports revealed, private foundations are among the least likely to measure nonfinancial return or to report other than anecdotally. Most private foundations therefore have a low willingness to disclose.
- ***Socially motivated individuals*** often have strong personal preferences for community impact and are accountable to no other third parties for any financial or other tradeoffs. At the same time, as with foundations, individuals have no stakeholders to whom they are required to report or disclose nonfinancial returns. Individuals therefore have a high willingness to pay but a low willingness to disclose.
- ***Banks subject to the CRA*** have a regulatory incentive to invest in low-income communities but are increasingly reluctant to trade financial return for the social impact resulting from CRA-compliant investments.[118] Banks have a low willingness to pay and, despite some reporting of anecdotal and demographic evidence, have demonstrated a relatively low willingness to disclose.
- ***Most nondepository financial institutions*** have a fiduciary duty to prioritize financial return and thus little appetite for "paying" for nonfinancial return. They also have little accountability for nonfinancial return and rarely measure or disclose that return, unless they are especially self-motivated or are required to by mandate or regulation. These investors have both a low willingness to pay and a low willingness to disclose.
- ***Mandate-driven nondepository financial institutions*** that are required to invest in community impacts share the same fiduciary duty to clients and the same reluctance to overtly sacrifice financial return for social return as ordinary nondepository institutions, demonstrating a low willingness to pay. Yet because they are accountable to the mandate, they are often obliged to evaluate and report performance, resulting in a higher willingness to disclose. Investors in this category include CalPERS and the BAML Capital Access Funds, which we discussed earlier.

117 CARS Rating System, www.carsratingsystem.net/ratings/ratedCDFIs.asp, accessed August 2010

118 Weech, "Observations," 31.

*Figure 4: Continua of Investor Preferences*

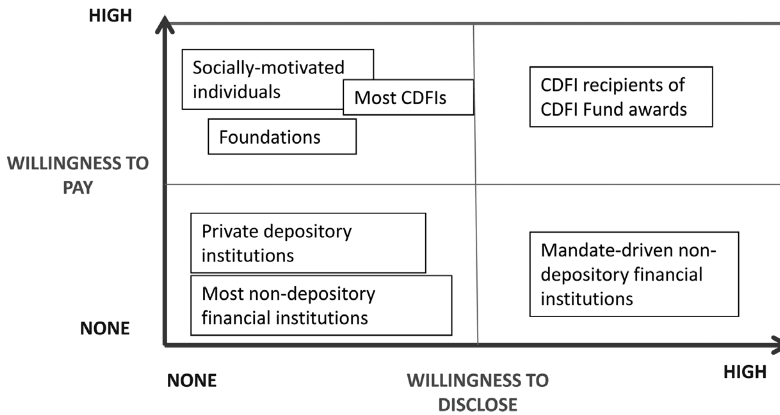


Figure 4, which illustrates the position on the two continua of the seven investor categories, as characterized by willingness to pay and willingness to disclose, provides some valuable guidance. It is clear that very few investors that place a high value on nonfinancial return are also willing to robustly measure and report that community impact. Moreover, the relationship between willingness to pay and willingness to disclose is complicated. Although willingness to disclose should and usually does increase with willingness to pay – as investors become more accountable for the higher value of nonfinancial return they seek – this is not always the case. Investors with a high willingness to pay, including most CDFIs, may believe they have nothing to gain from disclosure. In other words, their social mission, required by law, may be enough to satisfy client preferences for community impact. For investors with a lower willingness to pay, but a surprisingly high willingness to disclose, the motivation to disclose is typically involuntary – resulting from regulations or mandates. Because these investors are typically financially motivated, they are accustomed to providing a more rigorous, benchmarked, and attributable form of reporting.

By considering where investors locate in Figure 4, and cross-referencing this with the nonfinancial performance measurement tools that they currently use, our research also confirms two interesting patterns. As willingness to pay increases, nonfinancial performance measurement tends to become more widespread and more standardized. Meanwhile, as willingness to disclose increases, nonfinancial performance measurement becomes more robustly benchmarked, more independently verified, and more customized and costly. For example, investors using Pacific Community Ventures tend to have a high willingness to disclose but a low willingness to pay; investors using the CDFI Data Project generally have a low willingness to disclose but a high willingness to pay.

The precise form that nonfinancial performance measurement should take is undoubtedly unknown. The research suggests only that investor demand for nonfinancial performance measurement and accountability will, and should, determine that form. With this in

mind, Figure 4 provides some final, additional insights into the likely location of innovation among investors:

- *Investors with a high willingness to disclose but low willingness to pay,* such as mandate-driven nondepository financial institutions, are primarily concerned with ensuring that they communicate with stakeholders about the real but modest nonfinancial returns they generate. These investors are likely to contribute to innovation by refining the method and the effectiveness of the presentation and reporting of nonfinancial returns, including by incorporating benchmarking and other best disclosure practices.
- *Investors with a high willingness to pay but low willingness to disclose*, such as most investing foundations and CDFIs, are likely to drive innovation in the practices they need to more accurately quantify and evaluate opportunities with highly valued community impacts, particularly for the purpose of informing internal decisions.
- *Investors with both a high willingness to disclose and a high willingness to pay,* such as CDFIs receiving government funding, are likely to drive widespread innovation. These investors are demonstrably accountable for the community impacts that they and their stakeholders value highly. This group's incentive to invest in and support innovation is unambiguous.

There are as many opinions about the form that nonfinancial performance measurement will take as there are tools, practices, and investors. According to the Monitor Institute, the priority for impact investors is to "develop rigorous metrics for assessing the relative social and environmental impact of investments and portfolios within and across the sectors and geographies that matter to them."[119] This is a very different vision from that of one interview subject, who hoped simply that "organizations see the value of collecting at least the basic data" and that "anything beyond that is icing on the cake – it's a luxury." Whatever the end game, the process is certain to be investor-centered.

### *4.4 How Does Nonfinancial Performance Measurement Increase Community Impact Investing?*

As a final outcome of our new method for characterizing investors, it is instructive to consider the special role of disclosure.[120] Disclosure informs the relationship that an investor has with its own stakeholders, but also produces a positive and important externality: it provides latent sources of capital either "observing" or underinvested in the sector with access to market-level data to assist in valuing and benchmarking their own nonfinancial objectives. Turning to CalPERS again as an example, as a result of the high levels of disclosure in the California Initiative, every other nondepository institution is free to take note of CalPERS' performance and to benchmark their own nonfinancial return accordingly.

119 Freireich and Fulton, "Investing,"47.
120 Hagerman and Ratcliffe, "Increasing Access to Capital," 44.

This positive externality sits at the heart of a virtuous cycle of market development driven by innovation in nonfinancial performance measurement. This innovation allows investors participating in the market to more accurately value willingness to pay and to provide and demand more disclosure. More disclosure makes more information available to investors not participating in the market. As sources of latent capital better understand the value of nonfinancial return, some may enter the market with a willingness to pay, bringing more resources to the table and creating even more demand for innovation and accountability.

In summary, the very practice of nonfinancial performance measurement holds the promise of building scale in community impact investing – a conclusion with which Federal Reserve Chairman Ben Bernanke has concurred in relation to CDFIs, arguing in 2006 in a speech at the Greenlining Institute's Thirteenth Annual Economic Development Summit in Los Angeles, that "to attract more return-oriented investors, including both conventional investors and those with social as well as financial goals, CDFIs must demonstrate financial viability as well as the ability to fulfill the broader development mission."[121]

## Part V: Conclusion

The community impact investing industry is made up of numerous investors, each with different preferences for achieving nonfinancial return. Investors choose investments on the basis of these preferences, which are informed by strategic, operational, and cultural priorities; outside stakeholders; and the availability of actionable data. The tools and practices they use to measure performance also vary significantly. There are three major barriers to industry-wide nonfinancial performance measurement: diverse and ambiguous investor preferences, inadequate tools and practices, and lack of accountability for nonfinancial return.

Nonfinancial performance measurement provides the information investors need to satisfy their community impact objectives. In other words, investor behavior is informed by measurement tools and practices. This investor-centered perspective shifts the focus away from particular metrics as the focal point of innovation and asserts instead that a more complete understanding of investor preferences will lead to a more robust regime of measurement. To that end, the investor-centered framework provides an important perspective from which to consider four key questions and their respective answers:

1. *Does nonfinancial performance measurement really matter for investors?*
   Nonfinancial performance measurement informs investor preferences and allows them to better express their willingness to pay for nonfinancial return. Investors must decide independently whether nonfinancial performance matters. To the extent that it does matter, high-quality data and information are essential.

121 Bernanke, "By the Numbers," 4.

2. *If it does matter, is nonfinancial performance measurement even possible?* Nonfinancial performance measurement is already occurring, is already informing investor behavior, and will continue to improve because of innovation.
3. *If nonfinancial performance is possible to measure, what form should measurement take?* Innovation in nonfinancial performance measurement is likely to originate broadly, but driving it most strongly will be investors who are demonstrably accountable for the community impacts they and their stakeholders value highly. Accountability provides a critical incentive for innovation.
4. *How will nonfinancial performance measurement increase community impact investing?* Nonfinancial performance measurement increases community impact investing by providing investors with the ability to better express their willingness to pay and, through disclosure, by providing latent sources of capital with the information they require to value their own preferences and enter the market.

Innovation and accountability are the primary forces advancing nonfinancial performance measurement. The key question for the field is therefore one of degree. Which of the myriad current and prospective innovations, or efforts to increase accountability, is likely to suit the largest number of investors or the most influential among them? Although we did not evaluate any specific mechanisms for increasing innovation or accountability, salient questions and opportunities for future research might include the following:

- Is the industry capable of developing a standard set of voluntary principles and best practices, including a minimum level of measurement and disclosure, in order to mitigate differences and to guide investors?
- Should CRA reform include more robust community impact measurement and reporting requirements?
- Should the CDFI Fund, the largest single investor in the industry, require all CDFIs to report transaction-level data annually, and to make this information attributable and public?
- Are there sources of additional federal government funding for innovation in nonfinancial performance measurement?

Our findings may disappoint those anxious to find the ever-elusive silver bullet to nonfinancial performance measurement, but in fact there is considerable hope. Our research does not refute the possibility of ever discovering the silver bullet; rather, it demonstrates that the industry is a long way from identifying it. Improvements in measurement will occur as investors, service providers, and government continue to innovate. Our research highlights particular steps that stakeholders can take to move the field rapidly forward. For example, investors with similar preferences for nonfinancial return can converge around similar performance measurement strategies, thereby increasing standardization within their particular structural

categories and asset classes. Working groups can explore what different types of investors are seeking and perhaps shed light on the data already being collected but not disclosed. And public officials can investigate the significant impact government fiat could have on measurement innovation and disclosure.

There are certainly more questions worth asking and investigating. However, the point that bears repeating is that nonfinancial performance measurement, as it currently exists and in its possible future iterations, is indeed an important factor in scaling the industry. As industry actors better understand investors and their nonfinancial performance objectives, innovative measurement tools and practices will emerge. As a result, those investors who are observing but not yet participating in the industry will better understand both investment opportunities and their own willingness to pay for nonfinancial return, ultimately providing new capital for community impact.

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